PRISON INDUSTRY AUTHORITY
(A Component Unit of the State of California)

ANNUAL FINANCIAL REPORTS

Years Ended June 30, 2008 and 2007

PRISON INDUSTRY AUTHORITY

Table of Contents

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INDEPENDENT AUDITORS' REPORT

To the Prison Industry Authority Board
Folsom, California

We have audited the balance sheets of Prison Industry Authority ("CALPIA"), a component unit of the State of California, as of June 30, 2008 and 2007 and the related statements of operations and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of CALPIA's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly in all material respects, the financial position of CALPIA as of June 30, 2008 and 2007, and the changes in financial position and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with Government Auditing Standards, we have also issued our report dated December 4, 2008 on our consideration of CALPIA's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, grants agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and important for assessing the results of our audits.

Management's Discussion and Analysis on pages 3 through 9, is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Mayer Hoffman McCann P. C.

Bakersfield, California
December 4, 2008

PRISON INDUSTRY AUTHORITY

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL POSITION AND RESULTS OF OPERATIONS AS OF AND FOR THE FISCAL YEAR ENDED JUNE 30, 2008 AND 2007

INTRODUCTION - PRISON INDUSTRY AUTHORITY

The following Management Discussion and Analysis ("MD&A") applies only to the activities of the California Prison Industry Authority ("CALPIA") and should be read in conjunction with the basic financial statements and related footnotes.

CALPIA is a proprietary component unit of the State of California (State) and is accounted for in the Prison Industries Revolving Fund, which is an internal service fund in the State's Comprehensive Annual Financial Report. CALPIA does not receive a State appropriation.

Chapter 1549, Statutes of 1982, created CALPIA as a semi-autonomous state agency. The statutory purposes of the CALPIA are to:

- Develop and operate manufacturing, agricultural, and service enterprises that provide work opportunities for inmates under the jurisdiction of the California Department of Corrections and Rehabilitation ("CDCR");

- Create and maintain working conditions within enterprises, as much like those which prevail in private industry as possible, to assure inmates the opportunity to work productively to earn wages, and to acquire or improve effective work habits or occupational skills;

- Operate a work program for inmates that is self-supporting through the sale of products and services and reduces the cost of operation of the CDCR.

CALPIA is under the policy direction of an eleven-member board of directors, which reviews and approves the annual budget for the CALPIA. CALPIA manages over 60 manufacturing, service, and agricultural factories in 23 institutions. Administrative offices are located in Folsom, California. The goods and services produced by CALPIA's operations are sold principally to departments of the State of California and other governmental entities. CDCR is CALPIA's largest customer and accounted for 56% and 53% of all sales in the fiscal years ended June 30, 2008 and 2007, respectively.

Overview

CALPIA's vision of *"Building better lives for a better California"* associates the business goal of self-sufficiency with the program goal of reducing recidivism through ensuring inmate success. With respect to both financial and program goals, fiscal year 2008 was a successful one for CALPIA.

During fiscal year 2008, CALPIA earned $209.5 million of revenue which exceeds the previous year's total by $3.8 million (1.8%), a significant accomplishment in difficult economic times. While achieving record sales levels, CALPIA reduced Selling and Administrative expenses by $.6 million (2%), exclusive of the effect of implementing *Governmental Accounting Standards*

Board (GASB) Statement 45—Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions (OPEB).

Under GASB Statement 45, beginning with fiscal year 2008, the State is required to recognize the cost of retiree health benefit programs on an accrual basis rather than on a pay as you go basis. In its role of administering GASB 45 on behalf of the State, the State Controller's Office informed CALPIA that the Prison Industries Revolving Fund's share of the State's net OPEB obligation as of June 30, 2008, is $6.6 million. CALPIA recorded this amount as a "selling & administrative" expense on the operating statement. As a result, CALPIA's Statement of Operations reports an overall decrease in net assets (loss) of $3.0 million. Were it not for the $6.6 million OPEB expense, CALPIA would have realized a gain of $3.6 million. The State does not have a separate pool of assets available to finance future retiree healthcare benefits. In future years, CALPIA will actively monitor the costs of retiree health benefits in accordance with Generally Accepted Accounting Principles and the funding policies of the State. (The OPEB obligation is also discussed in the "Liabilities" section below.)

The foremost reason for CALPIA's ongoing success is the professionalism of our staff and the organization wide commitment to continuous improvement. Consolidating and improving product lines has encouraged sales, while monitoring material costs has resulted in adjusting pricing schedules appropriately. Of particular note, during fiscal year 2008, CALPIA upgraded manufacturing processes in the furniture (office, dormitory, and chair) and modular building factories to attain the ISO 9001:2000 standard, an international industrial standard for quality. CALPIA previously received ISO 9001:2000 certification in the general fabrication (modular furniture) factory. Achieving the ISO 9001:2000 standard affirms the quality of the products manufactured by CALPIA as well as the business practices that support them.

Programatically, CALPIA distinguishes itself through its innovative contributions to state government. In fiscal year 2008, CALPIA employed more than 6100 inmates per month in diverse manufacturing, service and agricultural enterprises. In addition to providing jobs, CALPIA invests in rehabilitation programs for inmates, including programs that offer vocational training and industry accredited certification in skills ranging from optometery and dental technology to laundry, commercial baking, welding, and metal stamping. CALPIA also provides technical education in commercial underwater diving, carpentry, and ironworking in partnership with trade unions who offer employment possibilities when inmates are released on parole. CDCR plays an invaluable role in these efforts by reimbursing CALPIA for a substantial portion of its vocational and career technical education program costs. Research indicates that the structure of CALPIA's programs, which combine manufacturing with education and training, is most effective in helping inmates succeed when they are returned to the community.

CALPIA understands that it faces enormous challenges brought about by the prevailing climate of economic uncertainty. The Governor is committed to a statewide no-growth spending policy that will limit the ability of State agencies to purchase CALPIA goods and services. Moreover, how the State elects to fund the OPEB obligation and to what extent the State will continue optional Medi-Cal optical benefits—CALPIA fills the Medi-Cal optical prescriptions—are examples of two issues of great importance to CALPIA. The State's fiscal 2008-09 Budget initially proposed eliminating the entire Med-Cal optical benefit for adults. Ultimately, a simple rate reduction of 10% was enacted, which will adversely affect CALPIA revenues in fiscal 2009.

As our customers benefit from quality goods and services, so do our inmate workers and, ulitmately, communities throughout California. In that spirit, CALPIA looks forward to sustaining its long tradition of supporting CDCR through expanding inmate employment opportunities in a fiscally responsible manner.

Condensed Balance Sheet

The following table presents the condensed balance sheets for CALPIA as of June 30, 2008 and 2007 and the change from year to year.

	2008	2007	Change
Assets			
Cash and cash equivalents	$ 60,207,601	$ 29,906,734	$ 30,300,867
Accounts receivable	13,713,014	14,379,156	(666,142)
Inventories	55,832,218	50,751,224	5,080,994
Capital assets, net	52,552,900	53,628,563	(1,075,663)
Other assets	828,748	1,050,954	(222,206)
Total assets	$ 183,134,481	$ 149,716,631	$ 33,417,850
Liabilities			
Accounts payable and accrued and other liabilities	$ 24,178,207	$ 21,225,747	$ 2,952,460
Deferred revenue	31,035,693	5,714,207	25,321,486
Workers' compensation reserves	12,062,775	10,600,000	1,462,775
Net OPEB Obligation	6,637,000	-	6,637,000
Total liabilities	73,913,675	37,539,954	36,373,721
Net Assets			
Invested in capital assets	52,552,900	53,628,563	(1,075,663)
Unrestricted net assets	56,667,906	58,548,114	(1,880,208)
Total net assets	109,220,806	112,176,677	(2,955,871)
Total liabilities and net assets	$ 183,134,481	$ 149,716,631	$ 33,417,850

Assets

Total assets increased by $33.4 million at June 30, 2008 compared to June 30, 2007, which is explained by a $30.3 million increase in cash and a $5.1 million increase in inventories offset by a $1.1 million decrease in capital assets and a $.9 million combined decrease in accounts receivable and other assets.

The $30.3 million increase in cash is explained by the positive cash flow from operating activities of $37.6 million and non-capital financing and investing activities of $.7 million, offset by the net outflow of $8.0 million from capital asset acquisitions and disposals. The most significant component of cash flow from operating activities is a $25.0 million advance received from CDCR for modular office buildings.

The build-up in inventories is the result of a concentrated effort to meet production demands, particularly in the general fabrication and modular building enterprises. The decrease in capital assets is due to depreciation and disposal of assets.

Liabilities

Total liabilities increased by $36.4 million at June 30, 2008 compared to June 30, 2007. This increase is mainly explained by the recording of a $6.6 million liability for Other Post Employment Benefits (OPEB) as well as a $25.3 million increase in deferred revenue. In addition, accounts payable and accrued liabilities and workers' compensation reserves increased by $3.0 million and $1.5 million, respectively.

Similar to other proprietary funds, the State annually allocates a portion of retiree health benefit costs to the Prison Industries Revolving Fund. Prior to fiscal year 2008, the State was on a "pay-as-you-go" allocation and funding policy. Effective with fiscal year 2008, in accordance with the requirements of GASB Statement 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions (OPEB)*, the State changed its allocation methodology to recognize the present value of future retiree healthcare benefits earned during the employee's working lifetime, including an amortization of the value of unfunded retiree healthcare benefits attributable to employee service earned in prior fiscal years. The State Controller's Office has determined that CALPIA's annual required OPEB contribution for fiscal 2008 is $10.1 million. Of this amount, CALPIA contributed $3.5 million; the balance of $6.6 million is accrued as a net OPEB long term liability.

The $25.3 million increase in deferred revenue corresponds to a $25.0 million advance from CDCR for the construction of Modular Buildings.

Condensed Statements of Operations and Changes in Net Assets

The following table presents the condensed statements of operations and changes in net assets for CALPIA for the fiscal years ended June 30, 2008 and 2007 and the change from year to year

	2008	2007	Change
Operating revenues- services and sales	$ 209,531,760	$ 205,734,145	$ 3,797,615
Cost of goods sold	170,446,971	172,170,450	(1,723,479)
Gross profit	39,084,789	33,563,695	5,521,094
Selling and administrative expenses	42,611,357	36,550,463	6,060,894
Operating loss	(3,526,568)	(2,986,768)	(539,800)
Non-operating revenues/(expenses), net	570,697	2,193,891	(1,623,194)
Decrease in net assets	(2,955,871)	(792,877)	(2,162,994)
Net assets at beginning of year	112,176,677	112,969,554	(792,877)
Net assets at end of year	$ 109,220,806	$ 112,176,677	$ (2,955,871)

Operating Revenues - Services and Sales

As represented in the table below, CALPIA sales increased $3.8 million (1.8%) in fiscal year 2008 from $205.7 million to $209.5 million. While manufacturing sales decreased by $7.0 million (6.1%), sales in the service and agricultural enterprises increased by $6.0 million (9.1%) and $4.8 million (18.2%), respectively.

In manufacturing, the combined sales of metal products, license plates, general fabrication (modular office systems), bindery, fabric products, shoes, and mattresses decreased $8.2 million. This outcome shows that state agencies had less discretionary funds available during fiscal 2008. The decrease also reflects that CALPIA's manufacturing enterprises experienced unprecedented sales in fiscal 2007, a period in which revenues increased $19.7 million (21%) over the prior year. In fact, when comparing between fiscal years 2006 and 2008, manufacturing revenues improved $12.6 million (13.5%).

Of the $6.0 million sales increase in service enterprises, $3.3 million (56.1%) occurred in food packaging sales and $1.9 million (32.1%) occurred in optical. Food packaging sales increased as a consequence of increased demand for peanut butter & jelly and juice products as well as price adjustments which took effect in the fourth quarter. The increase in optical sales is explained by additional orders for glasses from Caltrans and CDCR in response to the addition of polycarbonate lenses to the product line and increased caseload from Medi-Cal prescriptions.

The $4.8 million increase in agricultural sales is mainly attributable to structural price adjustments which were enacted to reflect market conditions in the dairy, poultry, and egg product lines.

Operating Revenues by Product Line	**2008**	**2007**	**Change**
Manufacturing:			
Furniture	$ 24,767,204	$ 24,959,996	$ (192,792)
Metal products	6,404,143	7,879,859	(1,475,716)
License plates	13,559,436	15,486,478	(1,927,042)
General fabrication	12,754,302	14,076,625	(1,322,323)
Bindery	2,959,896	3,898,042	(938,146)
Knitting mill	2,055,710	1,970,862	84,848
Fabric products	26,918,554	28,146,724	(1,228,170)
Silk screen	73,352	-	73,352
Shoe factory	4,497,770	5,387,355	(889,585)
Mattress factory	2,932,994	3,364,628	(431,634)
Cleaning products	3,767,089	3,716,789	50,300
Modular construction	5,938,451	4,711,299	1,227,152
Total manufacturing	106,628,901	113,598,657	(6,969,756)
Services:			
Meat cutting	10,677,467	10,398,216	279,251
Bakery	2,759,052	2,443,014	316,038
Coffee roasting	1,539,216	871,022	668,194
Food packaging	11,198,080	7,853,047	3,345,033
Metal signs	1,115,772	1,287,191	(171,419)
Printing	7,468,526	8,297,085	(828,559)
Dental lab	520,381	377,373	143,008
Digital services	-	103,911	(103,911)
Laundry	15,392,253	15,000,448	391,805
Optical	20,986,880	19,072,271	1,914,609
Total services	71,657,627	65,703,578	5,954,049
Agriculture:			
Dairy/farm	15,456,923	13,626,191	1,830,732
Crops	1,470,246	1,446,137	24,109
Poultry abattoir	6,290,546	5,654,854	635,692
Egg production	8,027,517	5,704,728	2,322,789
Total agriculture	31,245,232	26,431,910	4,813,322
Total operating revenues	$ 209,531,760	$ 205,734,145	$ 3,797,615

Cost of Goods Sold

Cost of goods sold decreased by $1.7 million (1.0%) in fiscal 2008 from $172.1 million to $170.4 million. As a percentage of sales, cost of goods sold were 81.4% and 83.7% in fiscal years 2008 and 2007, respectively. The decrease in cost of goods sold is the primary consequence of reduced sales in the manufacturing enterprises. Additionally, in certain enterprises, CALPIA reconfigured its product mix or focused sales on more profitable items. For example, “glass” lenses were eliminated from the optical product line, while sales of vertical files decreased in the metal product line, thereby improving the profit margins of those enterprises. As previously mentioned, CALPIA undertook a major effort to adjust prices in fiscal year 2008, particularly in the service and agricultural enterprises. This effort significantly contributed toward a positive change in profit margin.

Selling and Administrative Expenses

Selling and administrative expenses increased by $6.1 million (16.6%) in fiscal year 2008 from $36.5 million to $42.6 million. This increase is the result of recording of a $6.6 million OPEB obligation as a selling and administrative expense. Excluding the effect of the OPEB obligation, CALPIA reduced selling and administrative expenses by $.6 million (1.6%) overall.

PRISON INDUSTRY AUTHORITY

BALANCE SHEETS

June 30, 2008 and 2007

ASSETS

		2008		2007
CURRENT ASSETS				
Cash and cash equivalents				
Designated for capital assets expenditures	$	7,162,537	$	9,536,232
Other		53,045,064		20,370,502
TOTAL CASH AND CASH EQUIVALENTS		60,207,601		29,906,734
Accounts receivable		13,713,014		14,379,156
Interest receivable		370,414		193,906
Inventories		55,832,218		50,751,224
Other		458,334		857,048
TOTAL CURRENT ASSETS		130,581,581		96,088,068
CAPITAL ASSETS, NET		52,552,900		53,628,563
TOTAL ASSETS	$	183,134,481	$	149,716,631

LIABILITIES AND NET ASSETS

		2008		2007
CURRENT LIABILITIES				
Accounts payable	$	13,392,202	$	11,963,112
Accrued expenses and other liabilities		10,786,005		9,262,635
Current portion of workers' compensation reserves		1,210,599		1,434,835
Deferred revenue		31,035,693		5,714,207
TOTAL CURRENT LIABILITIES		56,424,499		28,374,789
LONG TERM LIABILITIES				
Workers' compensation reserves, net of current portion		10,852,176		9,165,165
Net OPEB obligation		6,637,000		-
TOTAL LONG TERM LIABILITIES		17,489,176		9,165,165
TOTAL LIABILITIES		73,913,675		37,539,954
NET ASSETS				
Invested in capital assets		52,552,900		53,628,563
Unrestricted net assets		56,667,906		58,548,114
TOTAL NET ASSETS		109,220,806		112,176,677
TOTAL LIABILITIES AND NET ASSETS	$	183,134,481	$	149,716,631

See Notes to Financial Statements

PRISON INDUSTRY AUTHORITY

STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS

Years Ended June 30, 2008 and 2007

	2008	2007
OPERATING REVENUES		
Services and sales	$ 209,531,760	$ 205,734,145
COST OF GOODS SOLD	170,446,971	172,170,450
GROSS PROFIT	39,084,789	33,563,695
SELLING AND ADMINISTRATIVE EXPENSES	42,611,357	36,550,463
OPERATING LOSS	(3,526,568)	(2,986,768)
NON-OPERATING REVENUES (EXPENSES)		
Interest income	1,367,022	1,100,692
Interest expense	(26,162)	(61,241)
Loss from disposal of capital assets	(363,693)	(485,775)
Other income (expense), net	(406,470)	1,640,215
TOTAL NON-OPERATING REVENUE, NET	570,697	2,193,891
DECREASE IN NET ASSETS	(2,955,871)	(792,877)
NET ASSETS AT BEGINNING OF YEAR	112,176,677	112,969,554
NET ASSETS AT END OF YEAR	$ 109,220,806	$ 112,176,677

See Notes to Financial Statements

PRISON INDUSTRY AUTHORITY

STATEMENTS OF CASH FLOWS

Years Ended June 30, 2008 and 2007

	2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash received from customers	$ 235,519,386	$ 205,979,724
Advances to other funds	(5,164,630)	(11,281,956)
Cash paid to employees	(61,753,515)	(61,992,130)
Cash paid to suppliers	(131,031,397)	(129,764,032)
NET CASH FLOWS FROM OPERATING ACTIVITIES	37,569,844	2,941,606
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Interest expense	(26,162)	(61,241)
Other non-operating income (expense), net	(406,470)	1,640,215
NET CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES	(432,632)	1,578,974
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Acquisitions of capital assets	(8,457,151)	(16,208,949)
Proceeds from sale of capital assets	430,293	446,139
NET CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES	(8,026,858)	(15,762,810)
CASH FLOWS FROM INVESTING ACTIVITIES		
Interest received	1,190,513	1,265,453
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	30,300,867	(9,976,777)
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	29,906,734	39,883,511
CASH AND CASH EQUIVALENTS, END OF YEAR	$ 60,207,601	$ 29,906,734

See Notes to Financial Statements

PRISON INDUSTRY AUTHORITY

STATEMENTS OF CASH FLOWS (CONTINUED)

Years Ended June 30, 2008 and 2007

RECONCILIATION OF OPERATING LOSS TO NET CASH FLOWS FROM OPERATING ACTIVITIES	**2008**	**2007**
Operating loss	$ (3,526,568)	$ (2,986,768)
Adjustments to reconcile operating loss to net cash from operating activities:		
Depreciation	8,738,829	8,351,989
Net effect of changes in:		
Accounts receivable	666,142	(1,782,106)
Inventories	(5,080,994)	(2,403,516)
Other assets	398,714	(318,683)
Accounts payable, trade	1,429,090	(130,718)
Accrued expenses and other liabilities	1,523,370	(1,234,659)
Deferred revenue	25,321,486	2,027,683
Workers' compensation reserves	1,462,775	1,418,384
OPEB obligation	6,637,000	-
NET CASH FLOWS FROM OPERATING ACTIVITIES	$ 37,569,844	$ 2,941,606

See Notes to Financial Statements

(1) Organization

The California Prison Industry Authority ("CALPIA") was established in 1983, as the successor to the California Correctional Industries ("CCI"). It is under the policy direction of an eleven-member board of directors and is a component unit of the State of California. CALPIA manages over 60 manufacturing, service, and agriculture factories in 23 institutions, that employ inmates at California's penal institutions within the California State Department of Corrections and Rehabilitation ("CDCR"). Administrative offices are located in Folsom, California. The products manufactured by CALPIA's operations are sold principally to departments of the State of California and other governmental entities.

(2) Summary of significant accounting policies

Basis of accounting – Revenues and expenses are recorded using the accrual basis of accounting. Under this method, revenues are recorded when orders are shipped and expenses are recorded at the time liabilities are incurred.

Governmental Accounting Standards Board Statement No. 20 ("GASB No. 20"), *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Funds Accounting*, established standards for accounting and financial reporting for proprietary funds. In accordance with GASB No. 20, CALPIA's proprietary fund accounting and financial reporting practices are based on all applicable GASB pronouncements as well as the following pronouncements issued on, or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements: Financial Accounting Standards Board ("FASB") Statements and Interpretations, Accounting Principles Board ("APB") Opinions, and Accounting Research Bulletins ("ARB") of the Committee of Accounting Procedures. As allowed under GASB No. 20, CALPIA has elected to apply applicable FASB pronouncements issued subsequent to November 30, 1989 that do not conflict with or contradict GASB pronouncements.

Cash and cash equivalents – Cash consists of deposits in the custody of the State of California Treasurer. Cash not required for current use, including restricted cash, is invested in the Surplus Money Investment Fund ("SMIF"). These funds are invested at the direction of the Pooled Money Investment Board and investments are limited by law to U.S. governmental securities, securities of federally-sponsored agencies, U.S. corporate bonds, interest-bearing time deposits in California banks and savings and loans, prime-rated commercial paper, bankers' acceptances, and negotiable certificates of deposits. These investments are carried at fair value. All deposits are insured by federal depository insurance or by collateral held by the State Treasurer's Office or by an agent of the State Treasurer's Office in the State's name.

Interest earned on cash invested in the State of California Treasurer's Surplus Money Investment Fund is prorated to CALPIA based on its average daily balance.

Cash and cash equivalents include cash on hand and temporary cash investments (including SMIF and funds restricted or designated for property and equipment acquisitions) with maturities of three months or less.

(2) Summary of significant accounting policies (Continued)

Governmental Accounting Standards Board Statement No. 3 as amended by Statement No. 40 requires that governmental entities provide disclosures regarding credit risk, custodial credit risk, interest rate risk, and concentration of credit risk. Funds deposited in pooled investments cannot be categorized under Governmental Accounting Board Statement No. 3 and 40 as the funds are commingled with other depositors.

Cash designated for capital asset expenditures – CALPIA segregates certain cash which is designated as to use. Designated funds represent designations of cash by the Prison Industry Board for certain capital expenditures.

The Prison Industry Board designated funds amounting to $7,162,537 and $9,536,232 for certain capital expenditures to be made during the years ending June 30, 2009 and 2008, respectively.

Concentrations of credit risk – Financial instruments which potentially expose CALPIA to concentrations of credit risk consist primarily of trade accounts receivable.

CALPIA's customer base includes departments of the State of California and other governmental entities. CDCR is the largest customer of CALPIA and accounted for approximately 56% and 53% of all sales in the fiscal years ended June 2008 and 2007, respectively. Management does not believe significant credit risk exists at June 2008 and 2007.

CALPIA and other state and local agencies' deposits are held in the pooled money account in the custody of the State Controller's Office, which is fully insured and collateralized.

Accounts receivable – CALPIA has no formal policy regarding the extension of credit and does not use an allowance for doubtful accounts because their customer base is primarily made up of state and local government agencies. Non-trade receivables are approximately $499,323 and $135,749 as of June 2008 and 2007, respectively. Historically, CALPIA has not experienced significant losses related to receivables.

Use of estimates in the preparation of financial statements – The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Inventories – Finished Goods and Work in Process inventory is valued at the lower of cost or market. Actual rates are developed for overhead to value the inventory. Raw Material costs used to value inventory are actual weighted average of purchases for each individual item.

Capital assets – Capital assets are stated at historical cost, net of accumulated depreciation. CALPIA has established a threshold of $5,000 for capitalization of depreciable assets. Depreciation is computed using the straight-line method over the estimated useful lives of the assets. The estimated useful lives range from 5 to 20 years for equipment, 5 to

(2) **Summary of significant accounting policies (Continued)**

Capital assets (continued) – 30 years for buildings and leasehold improvements, 2 to 3 years for livestock, and 20 to 25 years for orchards. Interest related to the cost of construction of certain assets is capitalized whenever debt is outstanding and the assets are constructed for use by CALPIA. Interest is amortized over the related assets' estimated useful lives. Expenditures for repairs and maintenance are charged to operations as incurred.

In the ordinary course of business, CALPIA opens and closes manufacturing facilities based on economic conditions and industry demand for products. Based on CALPIA's closure policy, management may recommend that the factory remain idle if at a later date it is probable that product demand will increase resulting in the factory being reactivated. If management determines not to reactivate a factory, CALPIA will take one of the following actions: (1) determine if the factory has alternative uses, (2) transfer equipment to operating factories, or (3) pursue other alternatives for disposal. Factories which are closed temporarily are retained in the property accounts as idle facilities and are not depreciated during the temporary closure.

For those facilities which have been closed and will be transferred to CDCR, the related assets are transferred at net book value and a gain or loss is recognized upon the transfer.

Asset impairment – As required by GASB No. 42, management periodically reviews long lived assets for impairments whenever events or changes in circumstances indicate that the service utility of an asset has declined significantly and unexpectedly. If the estimated undiscounted future cash flows are less than the carrying value, a write-down would be recorded to reduce the related asset to its estimated fair value. There were no circumstances or triggering events that indicated impairment for the years ended June 30, 2008 and 2007.

Compensated absences – It is CALPIA's policy to accrue for personal leave time, personal/Saturday holiday pay and vacation pay that has been earned but not yet taken by employees. A liability for compensated absences is accrued when incurred and reported in accrued liabilities on the balance sheet. CALPIA employees are not compensated for unused sick leave, but instead are credited with pension service time for unused sick leave. Accordingly, such convertible sick leave is not reflected in the accrued liability for compensated absences. Instead, it is reflected over time in the employer's pension contribution.

Deferred revenue – Deferred revenues represent advance payments from state agencies for the future delivery of products and services.

Operating and non-operating activities – Operating revenues are charges to customers for sales of products and services. Operating expenses consist of cost of sales and selling and administrative expenses. Selling and administrative expenses are comprised of distribution and transportation costs and central office costs. All revenues and expenses not meeting these definitions are reported as non-operating revenues and expenses.

(2) Summary of significant accounting policies (Continued)

Reclassifications – Certain amounts in the June 30, 2007 financial statements have been reclassified for comparative purposes to conform with the presentation in the June 30, 2008 financial statements.

(3) Accounts receivable

	June 30, 2008	June 30, 2007
California Department of Corrections and Rehabilitation	$ 8,105,517	$ 6,220,416
Other receivables	5,607,497	8,158,740
Total accounts receivable	$ 13,713,014	$ 14,379,156

(4) Inventories

	June 30, 2008	June 30, 2007
Raw materials	$ 30,177,379	$ 27,563,279
Work-in-process	12,324,373	10,228,316
Finished goods	13,330,466	12,959,629
Total inventories	$ 55,832,218	$ 50,751,224

(5) Capital assets

A summary of changes in capital assets during fiscal years 2008 and 2007 is as follows:

	Balance June 30, 2007	Additions	Deletions	Balance June 30, 2008
Equipment	$ 104,258,103	$ 4,995,015	$ (1,193,487)	$ 108,059,631
Buildings and leasehold improvements, net of transfers	36,013,415	1,593,640	-	37,607,055
Livestock	5,215,557	1,868,497	(1,966,700)	5,117,354
Orchards	923,506	-	-	923,506
Total	146,410,581	8,457,152	(3,160,187)	151,707,546
Accumulated depreciation and amortization	(92,782,018)	(8,738,828)	2,366,200	(99,154,646)
Capital assets, net	$ 53,628,563	$ (281,676)	$ (793,987)	$ 52,552,900

	Balance June 30, 2006	Additions	Deletions	Balance June 30, 2007
Equipment	$ 93,681,243	$ 11,737,947	$ (1,161,087)	$ 104,258,103
Buildings and leasehold improvements, net of transfers	33,507,350	2,590,165	(84,100)	36,013,415
Livestock	5,306,720	1,880,837	(1,972,000)	5,215,557
Orchards	923,506	-	-	923,506
Total	133,418,819	16,208,949	(3,217,187)	146,410,581
Accumulated depreciation and amortization	(86,715,302)	(8,351,989)	2,285,273	(92,782,018)
Capital assets, net	$ 46,703,517	$ 7,856,960	$ (931,914)	$ 53,628,563

Depreciation expense for the years ended June 30, 2008 and 2007 was $8,738,829 and $8,351,989, respectively.

(6) Accrued expenses and other liabilities

	June 30, 2008	June 30, 2007
Accrued leave time	$ 7,925,721	$ 8,165,543
Support charges due to CDCR	1,636,503	13,912
Inmate pay	402,132	395,412
Personal services	397,060	389,405
Sales and use tax	347,332	262,520
Accrued service and expenses	77,257	35,031
Total accrued and other liabilities	$ 10,786,005	$ 9,261,823

(7) Workers' compensation reserves

CALPIA is exposed to risk of losses related to torts, theft of, damage to, and destruction of assets, injuries to employees, and natural disasters. The State of California self-insures its workers' compensation claims. CALPIA's worker's compensation claims are administered by the State Compensation Insurance Fund as part of the overall State program. CALPIA currently reports claims, expenditures and liabilities when it is probable that a loss has occurred and the amount of that loss can be reasonably estimated. These losses include an estimate of claims that have been incurred but not reported. Consulting actuaries assist CALPIA in determining its liability for workers' compensation self-insured claims.

The amount of these liabilities was a discounted value of $12,062,775 and $10,600,000 at June 30, 2008 and 2007, respectively. CALPIA uses a range of discount interest rates from 0% to 5%. This liability is CALPIA's best estimate based on available actuarial information.

Fiscal Year	Beginning of Fiscal Year Liability	Current Year Claims and Changes in Estimates	Claims Payments	Legal and Administrative Expenses Paid	End of Fiscal Year Liability
2007-2008	$ 10,600,000	$ 2,986,201	$ (1,210,599)	$ (312,827)	$ 12,062,775
2006-2007	$ 9,181,616	$ 3,124,547	$ (1,434,835)	$ (271,328)	$ 10,600,000
2005-2006	$ 9,181,616	$ 2,068,270	$ (1,821,174)	$ (247,096)	$ 9,181,616
2004-2005	$ 9,181,616	$ 1,662,079	$ (1,442,797)	$ (219,282)	$ 9,181,616
2003-2004	$ 6,501,705	$ 4,272,511	$ (1,403,927)	$ (188,673)	$ 9,181,616

(8) Defined benefit pension plan

Plan description – The State is a member of the California Public Employee's Retirement System ("CalPERS"), an agent multiple-employer pension system which provides a contributory defined-benefit pension for substantially all State employees. CALPIA is included in the State Industrial and Safety Categories within CalPERS, thereby limiting the availability of certain CALPIA pension data. CalPERS functions as an investment and administrative agent for participating public agencies within the State of California. Departments and agencies within the State of California, including CALPIA, are in a cost-sharing arrangement in which all risks and costs are shared proportionately by participating State agencies.

CalPERS issues a publicly available Comprehensive Annual Financial Report that includes financial statements and required supplementary information for CalPERS. A copy of that report may be obtained by writing CalPERS, Central Supply, P.O. Box 942715, Sacramento, California 94229-2705, or by logging onto the CalPERS web site at www.calpers.ca.gov/.

The pension plan provides retirement benefits, survivor benefits, and death and disability benefits based upon employee's years of credited service, age and final compensation. Vesting occurs after five years of credited service except for second tier benefits, which require 10 years of credited service. Employees who retire at or after 50 with five or more years of service are entitled to a retirement benefit, payable monthly for the remainder of their lives. Several survivors benefit options which reduce a retiree's unmodified benefit are available.

Funding policy – Active members who participate in Social Security under the State Industrial Tier 1 category are required to contribute 5% of their annual covered salary after excluding the first $513 of gross monthly pay. Active members who do not participate in Social Security under the State Safety & Industrial Tier 1 categories are required to contribute 6% of their annual covered salary after excluding the first $317 of gross monthly pay. Active members who participate in Social Security under the State Industrial Tier 2 category are not required to make contributions to CalPERS.

CALPIA is required to contribute the actuarially determined remaining amounts necessary to fund the benefits for its members. The actuarial methods and assumptions used are those adopted by the CalPERS Board of Administration. The required employer contribution rate for the fiscal year ended June 30, 2008 was 17.345% and 18.835% for State Industrial and Safety, respectively. The required employer contribution rate for the fiscal year ended June 30, 2007 was 17.861% and 19.294% for State Industrial and Safety, respectively. The contribution requirements of the plan members are established by State statute and the employer contributions rate is established and may be amended by CalPERS.

Annual pension costs – For the year ended June 30, 2008 and 2007, CALPIA's annual pension cost and CALPIA's actual contribution amounted to $6,501,948 and $6,566,157, respectively. The required contribution for State Industrial and Safety Categories for the 2008 fiscal year was determined as part of the June 30, 2006, actuarial valuation using the entry age normal actuarial cost method with the contributions determined as a percent of pay. The actuarial assumptions included (a) 7.75% investment rate of return (net of administrative expenses), (b) projected salary increases that vary by duration of service ranging from 3.25 to 9.55%, (c) 3.25% overall payroll growth, and (d) 3.0% inflation adjustment. The actuarial value

(8) Defined benefit pension plan (Continued)

of CALPIA's assets was determined using a technique that smoothes the effect of short-term volatility in the market value of investments over a 15 year period. The plan's unfunded actuarial accrued liability (or excess assets) is being amortized as a level of percentage of projected payroll on a closed basis. The remaining amortization periods at June 30, 2006, the date of the most recent actuarial valuation, were 15 to 30 years for State Industrial Plans and 15 to 30 years for State Safety Plans.

Three-year trend information for CalPERS - State Industrial and Safety Categories (in thousands):

Fiscal Year Ended June 30	Annual Pension Cost (APC)	Percentage of APC Contributed	Net Pension Obligation (NPO)
2006	281,358	100%	$ -
2007	296,963	100%	$ -
2008	357,668	100%	$ -

(9) Postemployment benefits other than pension

Plan Description – CALPIA employees are employees of the State of California (the State). Consequently, CALPIA employees participate in the State pension and other postemployment benefit (OPEB) plan. The State plan is a single-employer defined benefit plan. A separate actuarial valuation was not performed for CALPIA. The State's OPEB plan does not issue a separate report.

The State provides medical, prescription drug, and dental benefits (healthcare benefits) to retired statewide employees. The authority for establishing and amending benefits lies with CalPERS and the State Legislature while the authority for establishing and amending the funding policy lies solely with the Legislature.

Funding Policy – The State has historically been on a "pay-as-you-go" funding and allocation policy; however, pursuant to the requirements of GASB No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, the State has amended its allocation methodology to include amortization of its accumulated unfunded post retirement obligations for its year ended June 30, 2008. The State has determined CALPIA's June 30, 2008 funding requirements as well as its related 2008 contribution credit. The amount allocated to CALPIA at June 30, 2008 representing the annual required contribution (ARC) was $10,086,000. Of this amount, $3,449,000 was estimated as contributed for 2008 and the balance of $6,637,000 was accrued as a liability.

(9) Postemployment benefits other than pension (Continued)

Annual OPEB Cost and Net OPEB Obligation – The State of California's annual other postemployment benefit cost is calculated based on the annual required contribution of the employer (ARC), an amount actuarially determined by the State in accordance with the parameters of GASB Statement 45. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost each year and amortize any unfunded actuarial liabilities (or funding excess) over a period not to exceed 30 years. The State determines the allocation for CALPIA based upon the relationship of active employee health benefit costs for CALPIA as compared to the total State active employee health benefit costs. The following table shows the components of CALPIA's allocation of the State's annual OPEB cost for the year, the amount credited to the plan, and changes in the net OPEB obligation.

Annual required contribution	$ 10,086,000
Amortization of prepaid contribution	-
Interest on net OPEB obligation	-
Annual OPEB cost (expense)	10,086,000
Contributions made	(3,449,000)
Increase in net OPEB obligation	6,637,000
Net OPEB obligation - beginning of year	-
Net OPEB obligation - end of year	$ 6,637,000

CALPIA's allocation of the annual OPEB cost, the percentage of annual OPEB costs contributed to the plan, and the net OPEB obligation for 2008 were as follows:

Fiscal Year Ended	Annual OPEB Cost	Percentage of Annual OPEB Cost Contributed	Net OPEB Obligation
6/30/2008	$ 10,086,000	34.2%	$ 6,637,000

The State's Actuarial Accrued Liabilities are measured as of July 1, 2007, based on census data as of March 1, 2007. As of June 30, 2008, the plan has not been funded. Therefore, there are no plan assets.

The Annual Required Contribution (ARC) is defined as the Normal Cost plus a 30-year level-percent-of-pay amortization of the Unfunded Actuarial Accrued Liability. The Annual OPEB Cost equals the ARC because the initial balance sheet liability is zero.

Projection of benefits for financial reporting purposes are based on the substantive plan and includes the types of benefits provided at the time of each valuation and the historical pattern of sharing of benefit costs between employer and plan members to that point. The actuarial calculations reflect a long-term perspective. Actuarial valuations involve estimates of the value

(9) Postemployment benefits other than pension (Continued)

of reported amounts and assumptions about the probability of events far into the future. Actuarially determined amounts are subject to continual revision as results are compared to past expectations and new estimates are made about the future.

All actuarial methodology, assumptions and results discussed herein were provided to CALPIA by the State of California.

Based on information provided to CALPIA by the State of California, in the July 1, 2007 actuarial valuation, the individual entry-age normal cost method was used. A pay-as -you go funding scenario was used by the State of California. Under the pay-as-you-go funding scenario, the State is assumed to finance retiree healthcare benefits from assets available in the general fund. The State's actuarial assumptions included a discount rate of 4.5%, and an annual healthcare cost trend rate of 10% initially, decreasing each year over the next ten years until the ultimate rate of 4.5% is reached.

The schedule of funding progress and employer contributions for the State of California for the year ended June 30, 2008 was not available.

(10) Related party transactions

The following related party transactions with CDCR occurred as of:

	June 30,	
	2008	**2007**
Assets:		
Accounts receivable	$ 8,105,517	$ 6,220,416
Liabilities:		
Accrued expenses and other liabilities	(1,636,503)	(13,912)
Deferred revenue	(26,030,015)	(3,276,690)
Revenues:		
Sales	116,398,550	109,722,259
Expenses:		
Support charges paid	(5,882,500)	(5,584,559)

(11) Contingencies

Litigation – CALPIA is involved in various legal actions arising in the ordinary course of business. In the opinion of management, after consulting with legal counsel, CALPIA intends to defend these cases vigorously and believes that the ultimate liability, if any, will not be material to the financial position of CALPIA.

(12) Commitments

Warranties – CALPIA provides a warranty on its office and miscellaneous furniture and bedding products of five years. CALPIA has not established a reserve for warranty expense. The effect on operations are deemed by management to be immaterial and costs are expensed when incurred.

Rental payments – Future minimum rental payments required under operating leases that have initial or remaining noncancellable lease terms in excess of one year as of June 30, 2008, are as follows:

Fiscal Year Ended June 30,	Real Estate
2009	$ 771,213
2010	685,232
2011	174,894
2012	204,132
2013	204,132
Thereafter	391,253
Total	$ 2,430,856

The following schedule shows the composition of total rental expense for all operating leases except those with terms of a month or less that were not renewed:

	June 30, 2008	June 30, 2007
Rent expense to nonrelated parties	$ 800,411	$ 796,355

ADDITIONAL INFORMATION

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INDEPENDENT AUDITORS' REPORT ON ADDITIONAL INFORMATION

To the Prison Industry Authority Board
Folsom, California

Our report on our audits of the basic financial statements of Prison Industry Authority for the years ended June 30, 2008 and 2007 appears on page 1. Those audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The Balance Sheet, Statement of Revenues, Expenses and Changes in Net Assets, and Statement of Cash Flows prepared in accordance with the State Controller's Office Instructions are presented for purposes of additional analysis and are not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Mayer Hoffman McCann P. C.

Bakersfield, California
December 4, 2008

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PRISON INDUSTRY AUTHORITY
INTERNAL SERVICE FUND

BALANCE SHEETS
CLASSIFIED IN ACCORDANCE WITH THE STATE CONTROLLER'S INSTRUCTIONS

June 30, 2008 and 2007
(in thousands)

ASSETS	**2008**	**2007**
CURRENT ASSETS		
Cash and pooled investments	$ 60,208	$ 29,907
Receivables, (net)	4,178	1,421
Due from other funds	9,602	12,701
Due from other governments	302	451
Prepaid items	458	857
Inventories, at cost	55,832	50,751
TOTAL CURRENT ASSETS	130,580	96,088
NONCURRENT ASSETS		
Depreciable capital assets:		
Buildings	6,037	5,480
Leasehold improvements	31,571	30,533
Equipment	108,060	104,258
Livestock	5,117	5,216
Orchards	924	924
TOTAL CAPITAL ASSETS	151,709	146,411
Accumulated depreciation:		
Buildings	(2,757)	(2,521)
Leasehold improvements	(20,696)	(19,152)
Equipment	(74,286)	(69,787)
Livestock	(871)	(824)
Orchards	(545)	(498)
TOTAL ACCUMULATED DEPRECIATION	(99,155)	(92,782)
TOTAL NONCURRENT ASSETS	52,554	53,629
TOTAL ASSETS	$ 183,134	$ 149,717
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES		
Accounts payable and other	$ 14,194	$ 12,762
Due to other funds	2,058	298
Advance collections	31,036	5,714
Compensated absences payable	7,926	8,166
Other current liabilities	1,211	1,435
TOTAL CURRENT LIABILITIES	56,425	28,375
NONCURRENT LIABILITIES		
Net OPEB obligation	6,637	-
Other non-current liabilities	10,852	9,165
TOTAL NONCURRENT LIABILITIES	17,489	9,165
TOTAL LIABILITIES	73,914	37,540
NET ASSETS		
Invested in capital assets	52,554	53,629
Unrestricted net assets	56,666	58,548
TOTAL NET ASSETS	109,220	112,177
TOTAL LIABILITIES AND NET ASSETS	$ 183,134	$ 149,717

PRISON INDUSTRY AUTHORITY
INTERNAL SERVICE FUND

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS
CLASSIFIED IN ACCORDANCE WITH THE STATE
CONTROLLER'S INSTRUCTIONS

Years Ended June 30, 2008 and 2007
(in thousands)

	2008	2007
OPERATING REVENUES		
Services and sales	$ 209,530	$ 205,734
OPERATING EXPENSES		
Personal services	(69,915)	(63,429)
Supplies	(3,686)	(3,838)
Services and charges	(130,718)	(133,102)
Depreciation	(8,739)	(8,352)
TOTAL OPERATING EXPENSES	(213,058)	(208,721)
OPERATING LOSS	(3,528)	(2,987)
NON-OPERATING REVENUES (EXPENSES)		
Interest income	1,367	1,101
Interest expense	(26)	(61)
Loss on disposal of capital assets	(364)	(486)
Other non-operating income (expense), net	(406)	1,640
TOTAL NON-OPERATING REVENUE, NET	571	2,194
DECREASE IN NET ASSETS	(2,957)	(793)
NET ASSETS AT BEGINNING OF YEAR	112,177	112,970
NET ASSETS AT END OF YEAR	$ 109,220	$ 112,177

PRISON INDUSTRY AUTHORITY
INTERNAL SERVICE FUND

STATEMENTS OF CASH FLOWS
CLASSIFIED IN ACCORDANCE WITH THE STATE
CONTROLLER'S INSTRUCTIONS

Years Ended June 30, 2008 and 2007
(in thousands)

	2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash received from customers	$ 235,519	$ 205,980
Advances to other funds	(5,165)	(11,282)
Cash paid to employees	(61,753)	(61,992)
Cash paid to suppliers	(131,031)	(129,764)
NET CASH FLOWS FROM OPERATING ACTIVITIES	37,570	2,942
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Interest expense	(26)	(61)
Other non-operating income (expense), net	(406)	1,640
NET CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES	(432)	1,579
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Acquisitions of capital assets	(8,457)	(16,209)
Proceeds from sale of capital assets	430	446
NET CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES	(8,027)	(15,763)
CASH FLOWS FROM INVESTING ACTIVITIES		
Interest received	1,190	1,265
NET INCREASE (DECREASE) IN CASH AND POOLED INVESTMENTS	30,301	(9,977)
CASH AND POOLED INVESTMENTS, BEGINNING OF YEAR	29,907	39,884
CASH AND POOLED INVESTMENTS, END OF YEAR	$ 60,208	$ 29,907

PRISON INDUSTRY AUTHORITY
INTERNAL SERVICE FUND

STATEMENTS OF CASH FLOWS
CLASSIFIED IN ACCORDANCE WITH THE STATE
CONTROLLER'S INSTRUCTIONS (CONTINUED)

Years Ended June 30, 2008 and 2007
(in thousands)

RECONCILIATION OF OPERATING LOSS TO NET CASH FLOWS FROM OPERATING ACTIVITIES	**2008**	**2007**
Operating loss	$ (3,528)	$ (2,987)
Adjustments to reconcile operating loss to net cash from operating activities:		
Depreciation	8,739	8,352
Net effect of changes in:		
Receivables	(2,757)	(946)
Due from other funds	3,099	(571)
Due from other governments	149	(100)
Prepaid items	399	(319)
Inventories	(5,081)	(2,403)
Other assets	177	(165)
Accounts payable and other	1,432	(185)
Due to other funds	1,760	(1,614)
Advance collections	25,321	2,027
Other current liabilities	(224)	58
Compensated absenses payable	(240)	434
Other liabilities	8,324	1,361
Total Adjustments	41,098	5,929
NET CASH FLOWS FROM OPERATING ACTIVITIES	$ 37,570	$ 2,942

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REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

To the Prison Industry Authority Board
Folsom, California

We have audited the financial statements of Prison Industry Authority ("CALPIA") as of and for the year ended June 30, 2008 and have issued our report thereon dated December 4, 2008. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered CALPIA's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of CALPIA's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of CALPIA's internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether CALPIA's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

We noted certain other matters that we reported to management of CALPIA in a separate letter dated December 4, 2008.

This report is intended solely for the information and use of management, others within CALPIA, and the Prison Industry Authority Board and is not intended to be and should not be used by anyone other than these specified parties.

Mayer Hoffman McCann P.C.

Bakersfield, California
December 4, 2008